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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1146

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case on November 15, 1966, affirming a determination by the Tax Court of the United States that petitioner owed deficiencies in income taxes aggregating $244,513.81 for the fiscal years ended March 31, 1957 through 1960.

CITATIONS TO OPINIONS BELOW

The Tax Court decision below is reported at 43 T.C. 783 (1965), and is printed in Volume II of the Transcript of Record (R. 573-654). The Opinion below of the United

States Court of Appeals for the Fifth Circuit (R. 719-720), which is printed in Appendix A hereto, *infra*, p. 1a, is reported in 368 F. 2d 231 (1966).

JURISDICTION

The judgment below of the United States Court of Appeals for the Fifth Circuit, which is printed in Appendix A hereto, *infra*, p. 2a, was entered on November 15, 1966 and issued as a mandate on December 23, 1966. (R. 721) A petition for rehearing (R. 722-732), nine copies of which are submitted with this petition, was denied on December 15, 1966 (R. 733). The jurisdiction of this Court is invoked under 26 U.S.C. § 7482(a) and 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. The specific issue involved is whether respondent was justified in revoking (in 1961) petitioner's exemption as a social club under Section 501(c)(7) of the 1954 Code for the years in question (fiscal 1957-1960) on the ground that petitioner accepted too much outside income in the form of bonuses and royalties, not from the conduct of a business—but from unsolicited oil and gas agreements with three oil companies with respect to land which petitioner acquired in 1928 solely for club purposes, with no awareness at that time of any oil potential, and which petitioner has at all times since used for the club purposes of hunting and fishing.

2. An underlying question of significant importance is whether, if any such quantitative test of passive income which may be received by a social club is a desirable test of exemption, the guidelines for such a test should be fashioned (a) by the Congress (see *Commissioner of Internal Revenue* v. *Clay Brown, et al.*, 380 U.S. 563), or (b) by the courts on a case-by-case basis where the exemption statute is silent on the question but has been construed to permit receipt of substantial amounts of non-business income through the disposition of surplus property not use-

able *per se* for club purposes: *Anderson Country Club* v. *Commissioner*, 2 T.C. 1238, (acquiesced in by the Commissioner, 1944 C.B. 2); *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616; and *Scofield* v. *Corpus Christi Golf & Country Club*, 127 F. 2d 452. (See also pp. 10-11, *infra*, for implied construction by the Treasury Department.)

STATUTE INVOLVED

The pertinent provisions of Section 501 of the Internal Revenue Code of 1954 are as follows:

> "Sec. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.
>
> (a) Exemption From Taxation—An organization described in subsection (c) or (d) or section 401 (a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503 or 504.
>
> * * * * * * * * *
>
> (c) List of Exempt Organizations—The following organizations are referred to in subsection (a):
>
> * * * * * * * * *
>
> (7) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder."
>
> * * * * * * * * *
>
> (26 U.S.C. § 501.)

STATEMENT OF THE CASE

Petitioner was organized as a hunting and fishing club on June 27, 1928 (R. 528, 574, 575), and it thereupon acquired approximately 6,000 acres of land in southwestern Louisiana solely for duck hunting and fishing, (R. 576). No oil or gas was discovered in this area until long after petitioner acquired its acreage. (R. 700) On April 11, 1935, petitioner executed its first oil and gas lease covering

its entire 6,000 acres with one Walter C. Peters, who shortly thereafter assigned it to Shell Oil Company. (R. 578-579) Because of such lease, respondent ruled in June 1936 that petitioner had forfeited its exemption and was required to file Federal income tax returns for 1936 and subsequent years (although it was held to be exempt for years prior thereto). (R. 579)

Petitioner filed returns and paid the Federal taxes for several years and then filed claims for refund on the ground it was an exempt social club, but its claims were rejected by respondent. In 1940, petitioner requested that its claims for refund be reconsidered in view of the decision of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616, but respondent refused to change his position.[1] (R. 579) On February 4, 1941, petitioner filed suit for refund of these taxes against the United States in the U. S. District Court for the Western District of Louisiana (R. 580). By letter dated November 21, 1941, the United States Attorney suggested to petitioner's attorney that further action on the refund suit be withheld pending a decision by the United States Court of Appeals for the Fifth Circuit in the case of *Scofield* v. *Corpus Christi Golf & Country Club* which was then on appeal. Such letter stated that the *Corpus Christi* case involved "issues identical to those involved" in petitioner's case. (R. 580) On April 16, 1942, the United States Court of Appeals held in *Scofield* v. *Corpus*

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[1] The reason stated in respondent's letter dated April 11, 1940 was as follows (R. 487):

> "The development of this lease is in direct conflict to the purpose of a hunting and fishing club. The fact that the lease made provision for receipts greatly in excess of the needs of the club and which could destroy the usefulness of the preserve to the members for financial reward, is proof that this lease was not entered into for the purpose of operating a hunting and fishing club."

Christi Golf & Country Club, 127 F. 2d 452, that the social club involved therein was exempt from Federal income taxes, and shortly thereafter petitioner received a full administrative refund of the taxes involved in its refund suit. (R. 581)

By letter ruling dated July 17, 1943, respondent restored, retroactive to 1935, petitioner's exemption as a social club. (R. 479-481) Petitioner's application for such restoration reflected that it had already realized $48,010.59 in bonuses, rentals and royalties from the 1935 Shell lease which was still in effect with respect to a reduced amount of acreage (on which two producing wells had been drilled). (R. 584-585)

Since the July 17, 1943 exemption ruling, the only oil and gas leases into which petitioner has entered have been two leases with Shell Oil Company,[2] two leases with Pan American Oil Company and one lease with Sohio Oil Company, and no well was drilled on petitioner's acreage as the result of any of these agreements. In each instance, such agreement was solicited solely by the lessee, and no negotiations for any agreement were ever initiated by petitioner. (R. 602) Since August 1959, only 580 acres of petitioner's 6,000 acres, consisting of 360 acres from the 1935 Shell lease and 220 acres subject to a subsequent unitization agreement with Shell Oil Company and others, have remained subject to oil and gas agreements. Petitioner has never had any working interest in any oil or gas lease, nor has it ever participated in any oil or gas

[2] The first of which was in effect a partial settlement (in 1952) of drainage problems with respect to acreage still under the 1935 lease (R. 586) and the second of which was entered into in 1957 primarily for the purpose of extending Shell's rights under the 1952 lease which otherwise would have expired unless Shell had drilled a well, the cost of which (petitioner long afterward discovered) was estimated by Shell to be at least $834,000. (R. 590-592).

operations. (R. 666) Petitioner has never paid any cash dividends or made any other distributions to its shareholders. (R. 611) Petitioner has held its oil and gas income for use in meeting various expenditures to further its objectives as a hunting and fishing club. (R. 604, 608-609, 612-613)

By letter to petitioner dated June 20, 1961, respondent revoked his tax exemption ruling of July 17, 1943, retroactive to the fiscal year ended March 31, 1957 and subsequent years.[3] (R. 605) Such revocation letter presumably arose from the fact that petitioner received a bonus of $384,000 in March 1957 for entering into a new lease with Shell Oil Company with respect to 5,640 acres (R. 592-593), and received $62,040 from Pan American Petroleum Corporation in 1959 in consideration for the right to conduct a geophysical survey of such 5,640 acres. (R. 601)

By a notice of deficiency dated August 31, 1961, respondent asserted alleged Federal income taxes due from petitioner for the fiscal years ended March 31, 1957 through 1960 on the ground that petitioner did not qualify for exemption from tax. (R. 463-473)

On October 20, 1961, petitioner filed a petition in the Tax Court of the United States contesting the asserted deficiencies. (R. 450-518) In its Opinion filed on March 17, 1965, the Tax Court upheld the contention of respondent. (R. 573-654)

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[3] It is submitted that the reason given in such letter for the revocation of exemption, namely "that your mineral leases have resulted in your receipt of substantial, recurrent income from sources not related to the basis for exemption under section 501(c)(7)" (R. 517), was to all intents and purposes, the same as that used (and later conceded to be erroneous by the exemption ruling of July 17, 1943. R. 480) to deny petitioner exemption in 1940. (See footnote 1, *supra*, p. 4)

Petitioner filed a timely petition for review in the United States Court of Appeals for the Fifth Circuit on June 29, 1965, and on November 15, 1966 the Tax Court was affirmed by a *per curiam* Opinion (R. 719-720) which cited as authority therefor that Court's 2 to 1 decision in *United States* v. *Fort Worth Club of Fort Worth, Texas,* 348 F. 2d 891.[4]

REASONS FOR GRANTING THE WRIT

1. It is respectfully submitted that in the absence of any finding by the Tax Court below that petitioner's oil and gas lease transactions constituted engaging in business,[5] the conclusion of that Court that petitioner was not an exempt social club within the meaning of Section 501 (c)(7) during the taxable years at issue, as well as the apparent basis for such conclusion, both of which were adopted in the Opinion by the United States Court of Appeals for the Fifth Circuit, are in conflict with other authoritative interpretations of such exemption statute. The basis for the Tax Court's determination that petitioner had forfeited its exempt status as a social club

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[4] See footnote 6, *infra,* at p. 8.

[5] The conclusion is inescapable from the record below that the Tax Court recognized that petitioner had not engaged in business in the usual sense (R. 440), but, notwithstanding this, considered the possibility of finding, on the authority of *Mauldin* v. *Commissioner,* 195 F. 2d 714, affirming 16 TC 698 (opinion by trial judge in the instant case), that petitioner did engage in business by merely executing and receiving income from unsolicited oil and gas leases or agreements. (R. 440-441) The Tax Court, however, refrained from making any finding that petitioner was engaged in business, presumably because it would be contrary to the record below that petitioner had never had a working interest in any oil or gas lease nor participated in any oil or gas operations. (R. 626, 666, 685-686, and pages 3 and 4 of the petition for rehearing in the Court of Appeals below, R. 725-726).

appears to be, not that petitioner was engaged in business,[6] but rather that its leasing transactions "were entered into 'for the purpose of profit' and that the profits therefrom have been both regularly recurring and substantial". (R. 643) Such a criterion for revoking a social club's exemption, in the absence of a finding that the club engaged in an outside business, not only appears to have no case support, but is in conflict with:

(a) The Tax Court's conclusion in *Anderson Country Club, Inc.* v. *Commissioner*, 2 T.C. 1238 (1943), acquiesced in by respondent, 1944 C.B. 2, that the plotting and sale by a country club of 24 lots over a twelve-year period at a substantial profit did not cause a forfeiture of the club's exemption. After noting the Government's contention in that case "that by selling the real estate in question at a profit over a considerable period of time, petitioner had forfeited the right to claim the exemption", the Tax Court stated at pages 1242 and 1243:

> "The respondent's regulations recognize the fact that an incidental sale of property does not extinguish the right to an exemption. Considering 'incidental' in its ordinary sense to mean collateral or subordinate to the principal purpose, we think there is ample evi-

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[6] In the absence of a finding that petitioner in the instant case was engaged in its lease transactions as a business, the reliance of the United States Court of Appeals for the Fifth Circuit on its own decision in *United States* v. *Fort Worth Club of Fort Worth, Texas*, 348 F. 2d 891 (1965), in affirming the instant Tax Court decision below, appears misplaced, since the Court succinctly summarized in its holding in that case as follows at page 892:

> "In reversing the decision of the district court, we *held only* that the Fort Worth Club, because of substantial and recurring outside *business* income, is not entitled to exemption from income tax as a social club under section 501(c)(7) of the Internal Revenue Code of 1954." (Emphasis supplied.)

dence that the sales in question were incidental to the primary reason for the club's existence.

"The fact that the profits were in some years substantial does not affect the incidental nature of the sales. * * *"

(b) The Opinions of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas,* 108 F. 2d 616 (1939), and *Scofield* v. *Corpus Christi Golf & Country Club,* 127 F. 2d 452 (1942), the only two cases to date in which the question has arisen whether the receipt of oil and gas income by a social club from its own land deprives it of its exempt status. In each instance, the Court of Appeals sustained the exemption of the social club. In the *Koon Kreek* case, the Court of Appeals held that the club's leasing activities and the receipt of substantial funds therefrom, did not result in a forfeiture of the club's exemption because it did not engage in those activities as a business. In the *Corpus Christi* case [7] the Court of Appeals held that the club's receipt of substantial amounts of oil revenues by way of bonus, delay rentals and royalties (a situation admittedly "identical" with petitioner's situation under the 1935 lease) from a lease on its land did not cause the loss of its exemption because they were "merely an incident to the ownership of the land", and the club was neither "actively engaged in operating non-club activities", nor did it derive its income "from the public generally". (127 F. 2d at p. 454) In each of these two cases the crucial factor to the United States Court of Appeals for the Fifth Circuit was the fact that the club had, as in the instant case, a non-working interest in the oil and gas lease involved and consequently had nothing to do with the operations thereunder. In its recent opinion in *United States* v. *Fort Worth Club of Fort Worth, Texas,* 345 F. 2d 52, the United States Court of Appeals

[7] In that case, unlike the instant one, the club was aware of the oil potential when it acquired the land. (R. 576 and 700)

for the Fifth Circuit emphasized the non-business nature of the oil and gas revenue received by the clubs in the *Koon Kreek* and *Corpus Christi* cases as the correct ground for the decisions reached therein, and it was on this basis that the Court of Appeals distinguished these cases from the commercial lease operations of the Fort Worth Club then before it.[8]

(c) The clear implication in respondent's sponsorship, through the Assistant Secretary of the Treasury, of companion bills, H.R. 15942 and H.R. 15943[9], in the Second Session of the 89th Congress (Appendix B, *infra*, pp. 1a to 9a), that there is no ban under present law on the receipt by a social club, or any other tax exempt organization, of outside *non-business income* and no legislative policy for invoking such a ban so long as the income is produced solely through the investment of a social club's own funds. This is made clear in Assistant Secretary Surrey's statement in support of the bills (Appendix B, *infra*, pp. 9a to 19a). He pointed out that all exempt organizations (including social clubs) would simply be taxed

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[8] Petitioner also brought to the attention of the Court of Appeals below the apparent conflict in respondent's own position as evidenced by statements in his brief on appeal in the *Fort Worth Club* case. He distinguished the *Koon Kreek and Corpus Christi* cases on the basis that all that was involved in those cases was the disposition "of surplus property (mineral rights) which was of no use to the club", and stated that the receipts therefrom fell in one of the several categories of club income held to be "merely incidental to the activities of a social club and not to destroy its exemption" namely, the category of "income from the sale of windfall property, such as mineral rights, which is discovered upon club property". See pp. 5 and 6 of the petition for rehearing in the instant case. (R. 727-728)

[9] Mr. Surrey testified as to such bills in Hearings before the Ways and Means Committee on August 29, 1966, pp. 19-25, and pointed out that the bills were the product of a joint study by the staff of the Joint Committee on Internal Revenue Taxation and the Treasury technical staff. (Appendix B, *infra*, p. 10a)

on their income from debt-financed investments (Appendix B, *infra*, pp. 16a to 17a):

> "* * * Under the bills, income would be subject to tax *only* if it meets two tests: it would have to be derived from property acquired or improved with borrowed funds, and its production would have to be 'unrelated' to the educational, charitable, religious, or other operations constituting the basis of the organization's tax exemption.
>
> "*Income produced by investments of an organization's own funds would be unaffected by the bills.* * * *" (Emphasis supplied)

Thus the Assistant Secretary's statement clearly implies that under present law a social club may, without losing its exemption, receive outside *non-business income* without limit [10] as to amount from its own property, and under the proposed bills this would be changed only as to debt-financed income.

In summary, the *Anderson Country Club, Koon Kreek* and *Corpus Christi* cases, and Assistant Secretary Surrey's representations to the Congress all clearly recognize that the passive receipt of even substantial amounts of non-business income does not deprive a social club of its exemption. The only possible basis for distinguishing the instant case, therefore, must be, as one of the Judges suggested to respondent's counsel at the hearing on the appeal below (R. 729), that the amount of such income which petitioner received was too much. It is respectfully submitted that the courts should not superimpose such a cut-off rule on the existing requirements for exemption under Section 501(c)(7) where the statute itself is silent in that regard.

The Congress reviewed and passed legislation with respect to the taxation of exempt organizations in 1950 (Ap-

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[10] This is consistent with respondent's statements in his brief on appeal in the *Fort Worth Club* case. See footnote 8, page 10, *supra*.

pendix B, *infra*, pp. 14a-15a), and in 1966 the above-mentioned two bills were introduced in Congress (one by the Chairman of the Ways and Means Committee) to amend such legislation based on joint studies by Congressional and Treasury staffs. Under such circumstances, if there should be a cut-off point on the amount of passive income which may be received by an exempt social club, it is respectfully submitted that the rule should be fashioned by the Congress and not the courts. The following observation of this Court in the case of *Commissioner of Internal Revenue* v. *Clay Brown, et al.*, 380 U.S. 563, 579 (1965) would seem to apply with equal force in this case:

> "The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. *We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.' American Automobile Assn.* v. *United States*, 367 U.S. 687, 697." (Emphasis supplied)

2. Clearly the questions presented by this petition for certiorari are of substantial importance in the administration of Section 501(c)(7) of the 1954 Code, for to the best of petitioner's knowledge, the Tax Court decision below, which was adopted by the United States Court of Appeals for the Fifth Circuit, is the first case in which a court has held that a social club not engaged in business loses its exemption merely because it realizes too much income from the disposition of its surplus property, consisting of mineral rights which were acquired merely as an incident to the ownership of land and which were of no use to the club.

The urgent need for the United States Supreme Court to resolve the above-noted conflicts between the decisions of the Tax Court and the United States Court of Appeals

for the Fifth Circuit below, on the one hand, and the above-noted other authoritative interpretations of Section 501 (c)(7), on the other hand, is highlighted by the extreme position recently taken by respondent as to the receipt of passive non-business income of a social club in Revenue Ruling 66-149, I.R.B. 1966-22, 17. Such Ruling states (p. 18) that "a social club is not exempt from Federal income tax as an organization described in section 501(c)(7) of the Code where it regularly derives a substantial part [11] of its income from nonmember sources such as, for example, dividends and interest on investments which it owns". While petitioner does not believe that such quoted statement correctly reflects present law, particularly in the light of Mr. Surrey's above-quoted testimony, yet such Revenue Ruling increases the need for the Supreme Court to determine the nature of the outside non-business income which a social club may realize without forfeiting its statutory exemption and decide whether existing law imposes any quantitative limitation on such income. Undoubtedly, many social clubs have relied upon the correctness of the above-noted prior court decisions in utilizing outside income of a purely passive nature to carry out their exempt purposes.

The problem is particularly acute for those social clubs, which, like the instant petitioner, find that they have potential "windfalls" [12] in the form of subsequently-discovered natural resources or appreciation in property acquired in good faith solely for club purposes which, *per se*, cannot be used for such purposes. Must they refrain from converting such increments and using the proceeds for club purposes? Must they, in any event, limit such conversion and use to a relatively small amount or percentage each year? If the decisions below in the instant case and

[11] In Revenue Procedure 64-36, 1964-2 C.B. 962, 963, respondent sets forth as an audit technique for determining when such outside income becomes substantial the cut-off point of $2,500 annual gross receipts or 5% of total annual gross receipts.

[12] See footnote 8, p. 10, *supra*.

Revenue Ruling 66-149 referred to above are valid, social clubs which find themselves so situated must do just that or risk losing their exemption because either a realization or a distribution of such increments can cause a forfeiture of exemption. It is respectfully submitted that, in the absence of statutory language in Section 501(c)(7) which clearly imposes such a harsh dilemma, the Courts should not infer any Congressional intent to do so. In any event, there is obviously an urgent need for a clarifying decision by the Supreme Court in this area.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Certificate of Service

It is hereby certified that on this day personal service of a copy of this Petition for Certiorari has been made on the Solicitor General of the United States and on Honorable Mitchell Rogovin, Assistant Attorney General of the United States, in compliance with Paragraph 2 of Rule 33 of the Rules of the Supreme Court of the United States.

Dated: 14th day of March, 1967.

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